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# Governance Aspects of the East Asian Financial Crisis

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## GOVERNANCE ASPECTS OF THE EAST ASIAN FINANCIAL CRISIS[1]

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The authors dedicate this paper to Mancur Olson, who not only encouraged them to study this topic but in his last weeks contributed intriguing suggestions in oral remarks at seminars held at IRIS and USAID in January and February, 1998. While this paper represents an attempt to extend the analysis he began to develop during those weeks, the process of writing it was immeasurably impoverished by his absence.

## I. Introduction

Before June 1997, many economists (e.g., Stiglitz) were invoking successful governance, especially in relation to capital markets, as a principal factor underlying the so-called East Asian Economic Miracle. Since mid-1997, poor governance, especially in relation to capital markets, has been frequently mentioned as a major cause of the so-called East Asian Financial Crisis. Clearly, these apparently conflicting views raise important questions about the optimum role of government in developing economies.

This paper is written on the premise that governance issues were important in the East Asian crisis. In other words, we hypothesize that transparency and accountability in macroeconomic policymaking, in the operation of the financial system, and in corporate governance do serve to lessen a country's vulnerability to financial crises and to strengthen the ability to deal with crises when they occur. We hypothesize as well that a democratic political system, in which leaders are held accountable to their electorate by both direct election of the executive and an elected legislature—as well as by an independent judiciary and a free press and civil society—is less likely to collapse in the face of economic and financial difficulties than is a country run by an autocratic government, which imposes severe restraints on the public expression of opinion and dissemination of information.[2] And the former type of government is more likely

[1] The authors are indebted to Omar Azfar, Charles Cadwell and Todd Sandler for their helpful written comments, and have also benefited from the oral comments of various economists attending a workshop on this paper at USAID headquarters on January 20, 1999, and the conference on Market-Augmenting Government on March 26-27, 1999. These comments have in part been incorporated into the present revised draft. Remaining shortcomings of the paper are the responsibility of the authors, who will attempt to remedy them in the final version.

[2] Such limitations include: parties that are outlawed; a controlled press; restrictions to freedom of speech and assembly; the lack of an independent judiciary; and in general, no enforced constitutional rights of individuals ("human rights").

than the latter to reach consensus on, and implement, a painful but necessary program of economic stabilization and restructuring.[3]

To some observers of the financial crisis, questions of governance are coming from the wrong corner. They believe that this crisis is just another of the "mania, panics, and crashes"[4] that have marked the history of capitalism since its earliest days. According to this line of reasoning,[5] the most seriously affected countries (MSAs) in Asia, Eastern Europe, and Latin America were in large part victims of the herd mentality of international investors—and in better-informed versions of this view, of domestic investors as well.[6] It is evident that financial panic was triggered by excessive short-term foreign borrowing in the immediately preceding years; that it was exacerbated by fixed exchange rates that the authorities tried to support after their currencies had become clearly overvalued; and that the combination of global financial market and capital account liberalization during the last decade, in conjunction with technological and financial innovations over the past quarter-century, has greatly increased the capacity of markets to overwhelm any attempts of central banks to intervene successfully in foreign exchange or financial markets to stem destabilizing capital movements. It is equally evident that emerging market economies, with their relatively incomplete and poorly supervised financial sectors, and their still not fully developed economies, have been more vulnerable to such capital movements than the advanced industrial countries with their deeper and wider markets for goods and services, and their more fully developed and better supervised capital markets. One important corollary of this argument was that it was a mistake for the emerging market countries to remove most or all of their controls on inward and outward capital flows in the 1980s and 90s, and to liberalize domestic financial markets as rapidly and broadly as they did, without corresponding improvements in the supervision and regulation of those markets.

While the views just summarized, and econometric evidence prepared by Radelet and Sachs,[7] undoubtedly tell an important part of the story, there are questions that remain unanswered. The fact that "corruption" variables do not explain much of why some countries suffered greatly from financial crisis and others much less so, does not mean that governance issues are irrelevant in this context. For instance, it is our view that the excessive accumulation of short-term foreign currency liabilities by banks and large corporations, and weak prudential supervision of financial

[3] A case like Russia, where there are free elections but still relatively undeveloped governmental and political institutions, and the country is effectively run by a tiny political and economic elite, is an intermediate case between autocracy and democracy.

[4] This is the title of Charles Kindleberger's excellent book on financial crises.

[5] See Radelet and Sachs (1998).

[6] See IMF (1995), which points out that most of the net capital outflow from Mexico in 1994 and early 1995 was accounted for by its own residents.

[7] Radelet and Sachs (1998), 44-49.

institutions, are, far from being "explanatory variables," themselves phenomena that social scientists must seek to explain. While some empirical evidence is alluded to, the paper's main aim is to suggest questions for further research rather than providing conclusive answers.

Before proceeding further, a semantic note is in order. "Governance" is a word much used and abused of late; its literal meaning, "the act, process or power of governing" is in itself not very revealing. In this paper, the concern is specifically with various aspects of "economic governance," that is, the way in which economic life is governed and regulated—which, as we shall try to make clear (see Section IV), does not mean solely governance by the government. Economic governance has various aspects, and the paper is divided accordingly. Because the political basis of economic governance is, in our view, so crucial for the way in which different aspects of economic governance operate, it is discussed first, in the following section. Sections III and IV deal, respectively, with the governance of macroeconomic policy making, and the interrelated issues of financial and corporate governance. Section V analyzes proposals and current realities relating to international macroeconomic and financial governance, followed by a brief concluding section.

## II. The Political Basis of Economic Governance

Economic governance in a market economy consists in part of direct control or indirect influence exerted by the government and in part of governance exercised within markets themselves; but even self-governance by markets operates within the legal, judicial and regulatory framework that has been erected and is supported by the government. Mancur Olson called the optimum role of government in this context "market-augmenting government," and he and his colleagues have described aspects of this type of economic governance.[8] Market-augmenting government, as discussed in these papers, not only includes creation of institutions fostering growth and investment but also maintenance of a proper macroeconomic environment. Turning to the East Asian financial crisis, we encounter the dilemma, which Olson himself puzzled over in his last weeks, of how the same governments that were praised for propagating the "East Asian Miracle" are now being equally blamed for the East Asian crash. What was before perceived as the careful government direction of investment resources is now being seen as self-interested speculation and predation; the formerly extolled networking among economic players—an essential aspect of the "Asian" or "Japanese" model of economic management—is now derided as "cronyism."

[8] See Olson (1996) and (1998), as well as Lanyi/McMullen/Meagher (1997) and Cadwell (1999).

This puzzle of East Asian economic governance suggests, upon reflection, three very different and independent dimensions of economic governance and its political basis. All three were indicated by Olson in his initial reflections on the problem. First, there is the question of *economic governance regime*: what are the relative costs and benefits of a system that depends on discretionary decisions by the government, compared to those of a system in which the government operates in an arm's length mode through impartial rules and regulations? Second, there is the *time dimension*: is it possible that the nature of the ideal market-augmenting government changes as the economy develops, so that the kind of government intervention in the economy which works very well at early stages of development works less well when markets have evolved to a more advanced state and are better integrated with the world economy? Finally, there is the issue of *political regime*: can we say anything about the ideal degree of autocracy or democracy in a market-augmenting government, given that most countries in the East Asian region have elements of both types of regimes in their system? Is one type of government or another better suited to earlier or later stages of development?

## 1. Economic Governance Regimes

There is little debate about what constitutes the desirable outcomes of the governmental interaction with the economy. Nobody doubts that a stable macroeconomy, human capital development, openness to international trade and investment, market-determined prices, and high rates of saving and investment, together tend to produce sustainable economic growth and the basis for a rise in living standards for the broad mass of the population.[9] What should be the role of government in achieving these outcomes? We propose to discuss this issue by considering two polar alternatives—a regime that depends on a high degree of direct intervention in the economy by the government, and another in which government operates at arm's length from individual enterprises, setting and enforcing rules and creating a general environment for business rather than directly conducting business itself. In discussing the alternatives of discretionary and arm's-length regimes, we recognize that in the real world all governments to some extent employ both of these governance techniques, but with a wide range of relative emphases between the two.

To analyze the relative costs and benefits of these two approaches to economic governance, it is helpful to employ the concept of market-augmenting government. The key point here is that market-augmenting government has a different meaning in an environment of nonexistent or poorly developed markets than in an economy of highly developed markets. In the latter instance, there is wide consensus that the role of government is to provide a secure, stable setting, under the rule of law, with appropriate regulations to protect the public from private

[9] For evidence on this point, see Azfar (1999).

predation or negative (e.g., environmental) externalities. In the case of poorly developed markets, however, there is a strong argument that governments need to take steps to create special inducements for the private sector to initiate types of economic activities which, in the absence of such government action, would not come into being. Although the need for such government action is far from universally accepted,[10] there can be little doubt that as a historical fact the creation of basic infrastructure has normally required government initiative, and that beyond this, pro-active government interventions of this type have frequently contributed positively to economic development. The latter point is demonstrated by the record of the East Asian countries, and other evidence such as that provided by Wallis.[11]

A cost-benefit calculus of discretionary government intervention in the economy would thus begin with the following benefits:

1. Creating, or inducing the creation of, missing (or barely existing) markets;
2. Mitigating collective action problems—e.g., by government action to create the infrastructure necessary for further market-based development.
3. Mitigating information problems by collecting and disseminating information.

At the same time, a great deal of modern economic literature has discussed the various costs and distortions created by government intervention in the economy. These could be discussed at great length, but suffice it to summarize the costs of such government intervention as follows:

1. Creating rents for private sector entities and inducing the latter to engage in rent-seeking behavior;
2. Encouraging soft-budget constraints for favored industries and firms;
3. Distorting resource allocation by substituting political rather than strictly economic criteria for channeling resources to particular sectors or activities;
4. Creating greater opportunities for government failure (poor decisions, corruption).

The balance of costs and benefits of government intervention will depend on the particular circumstances of a country during a particular period of time. We shall therefore next examine

[10] Some economic thinkers, following Adam Smith, are skeptical about proactive enteprise and market creation by governments even at early stages of economic development. Smith, mirroring primarily British experience, believed that infrastructure should normally be self-financing through tolls and fees (Smith, 1776, 1904, Book V, Chapter I, Part III). Of course, such infrastructural development utilizing private resources presupposes adequately functioning markets and a stable polity.

[11] See the following sub-section of this paper.

how the optimum mode of market-augmenting government might change as an economy develops over time.

## 2. The time dimension of economic governance

It is evident, from the foregoing enumeration of costs and benefits, that the marginal benefits of government intervention decline as the stock of infrastructure grows and markets develop. At the same time, the costs of intervention remain at least constant with growing infrastructure and markets, and are possibly rising (as a growing private sector competes for rents). Thus, while economists are in the habit of regarding economic systems as ideal types, the reality of both economic and political life is one of evolution.

Market-augmenting government is commonly defined[12] as providing a setting for existing markets to function successfully. At an early stage of development, particular markets may be nonexistent or relatively well-developed; and at any given point of time, different markets may be at different stages of development. As a general rule, however, more pro-active government intervention may be called for at early stages of economic development in order to establish or develop particular markets—intervention of a sort that at later stages of development would be considered counterproductive. At the earlier stages, it may be less costly and more efficient for governments to directly substitute for missing markets than to build up market-supporting institutions and wait for markets to arise. As markets develop, however, the optimal market-augmenting policies would change to those that enhance market-supporting institutions, keeping an arm's-length relationship with the private sector. This is so because, as markets develop, there is a rise in the ratio of cost to benefits of pro-active government intervention. Thus, as an economy grows and price systems become more informative and effective, there will be less need for intervention and greater distortions will result from government intervention.

The potential time dependence of optimal government policies is not a new idea in economics. The old infant-industry argument is based on the notion that government intervention to compensate for market failure at an early stage of development is justified but should be withdrawn at a later stage. A more recent example of this idea is the growing acceptance of privatizing state-owned enterprises, even if it is acknowledged (by some, not all, observers) that the original involvement of the state in creating or taking over such enterprises might have been justified or even necessary. Another example is the argument, which has become popular in the current financial crisis, that restrictions on international capital movements, which might be inappropriate for advanced industrial countries, are needed for countries with incompletely developed and poorly regulated financial systems.

[12] See references given in footnote 8.

Rajan and Zingales (1998) have pointed out the potential time dependency of optimal systems, though they investigate the optimal systems for firms, not for governments. They argue that as markets develop, optimal systems for transactions change from "relationship-based" to "arm's-length" systems. Unlike our paper, however, they treat institutions as a semi-exogenous variable and as a determinant of optimal systems for transactions in the private sector. At early stages of market development, institutions for third-party enforcement, in their terminology contractual "infrastructure," are very weak and prices are not very informative, so that relationship-based systems—for example, a universal banking system—could work better than arm's-length-based systems that require contract enforcement and rational prices. They argue that as the contractual infrastructure develops and prices become more informative, arm's-length, competitive, Anglo-Saxon systems become increasingly preferable for private transactions. This conclusion implies, in our view, that an interventionist approach by the government, based on selective encouragement of particular sectors and firms, and involving direct relationships between government officials and favored private sector players, is more consistent with optimal systems at an earlier stage of development than at a later stage.

Another interesting example of the time dependence of government intervention is provided by Wallis (1999), who shows how, in the early to mid-Nineteenth Century, American states began to move from restrictive chartering practices—for example, granting operation rights to only a handful banks—to liberal incorporation laws. Wallis argues that this move laid the basis for an efficient economic system, especially in the financial sector, and while the timing of this move from "relationship-based" to "arm's-length" systems depended critically on the fiscal interest of each state, the initially more interventionist policies may well have been necessary for creating still nascent financial and transportation systems.

In East Asia, there were many examples of pro-active intervention by national governments at early stages of development. Examples of such intervention include: the Korean government's big push from the 1960s on to build heavy and chemical industries through a variety of subsidies, preferences, and special financing arrangements, often directed at individual firms; Taiwan's import-protective policies in the 1950s, and Thailand's similar policies in the 1970s; and state industrial investment in Indonesia both under Soekarno up to 1966 and again starting with the oil boom of the 1970s. Japan, of course, provided an example with its apparently successful use of directed credits and a protected domestic market, and the discretionary assistance rendered by the Ministry of International Trade and Industry (MITI) with regard to foreign exchange allocation[13] and the acquistion of foreign technology. Such policies were widely followed in other developing countries, too, but the fast-growing Asian economies were distinguished by their

[13] This was in the period before foreign exchange liberalization.

flexible response to internal and external changes, switching at later stages of their development to an export-promoting strategy that required broad liberalization of their financial, international trade, and foreign exchange regimes. It should be added that the influence of selective government intervention at both earlier and later stages of development is a hotly debated issue that is inherently difficult to resolve, as it involves not only comparative statics but dynamic issues with regard to saving and investment incentives.[14]

The question of appropriateness of particular policies to the stage of economic development is broadened in the following sub-section of this paper to encompass the issues of whether a particular type of political regime is especially appropriate at a particular stage of development, and whether the authoritarian regimes that proved successful in past decades in East Asian countries may be less appropriate as markets in those countries become more developed.

### 3. Political regime.

It should be stated at the outset that there is no one-to-one correspondence between the types of economic governance regime and political regime prevailing in a country. Discretionary and arm's-length approaches can each be found among autocratic and democratic regimes. The autocratic-discretionary combination is exemplified both by the Stalinist regimes (and some of their less oppressive successors) and by some of the relatively market-oriented Asian regimes of past decades, such as those of Suharto in Indonesia or Chung Hee Park in Korea. The autocratic-arm's-length combination is more uncommon, but has occasionally been found in Latin America—for instance, in Chile under Pinochet. The democratic-discretionary combination flourished for decades in South Asia—India and Sri Lanka—and also arguably in post-war Japan, while the democratic-arm's-length mode is typified by the United States, the United Kingdom in recent years, and to a lesser extent by the other Western European democracies.

As Rodrik and others have noted, economists and donor-country politicians in the 1980s often viewed good economic policy "as requiring 'strong' and 'autonomous' (if not to say authoritarian) leadership." Anyone associated with the International Monetary Fund (IMF) or World Bank during this period can testify to the admiration of those organizations' staffs for the regime of General Pinochet in Chile, and their relief that it was he and not Allende that had been at the helm there since 1974. Likewise, the World Bank's 1993 study, *The East Asian Miracle,* is fulsome in its praise of Asian national leadership in the period from the 1960s to the early 1990s. Technocrats found authoritarian regimes appealing during this period because, for the most part, these regimes chose proper macroeconomic policies and, to some degree, institution- building

[14] Discussion of selective government intervention strategies can be found in World Bank (1993); Krugman (1994); Radelet, Sachs and Cook (1999); and Porter and Takeuchi (1999).

activities as well, and were able to impose their will unhampered by the party conflicts and special interests that often stifle economic policy formulation and implementation in democracies.

However, these views were informally held. In their writings, economists were generally agnostic with respect to the relevance of political regimes to economic reform. It is only recently, in the wake of the crisis, that one occasionally encounters advocacy of going beyond "first-generation reforms"—reforms in fiscal, monetary, exchange rate, pricing, and subsidy policies—and "second-generation reforms"—institutional improvements in such areas as tax administration, budgetary formulation and monitoring, state enterprise privatization, strengthening regulation of financial institutions, and civil service reform.[15] There is now talk, especially in the Indonesian context, of the importance of political reforms, or what might be called "third-generation reforms," ostensibly to strengthen the long-term sustainability of the other reforms. But here again, the thinking on this subject up till now has been, at best, sketchy.

As Gourevitch[16] has trenchantly observed, over the years theories have been propounded, and evidence accumulated, that could be used to support one of the following conflicting propositions: markets require democracy, markets require authoritarianism, democracy requires markets, and democracy requires centralized planning and public ownership. In fact, one can find instances of both democratic and relatively authoritarian regimes that have supported sustained market-oriented development. Conversely, one can find instances of both democratic and authoritarian regimes under which the economy has been stifled by excessive controls, inefficient state enterprises, and pervasive official corruption. The interesting question, perhaps, is to find the right match, in Gourevitch's terms, of "form and content": form of government and content of economic policy. In the East Asian case, the question might be put how relatively authoritarian regimes that successfully supported essentially market-oriented and outward-oriented economic development proved unsustainable, either in the positive sense that they evolved into democratic systems (as in Korea) or in the sense of encountering economic and political collapse (as in Indonesia).

Mancur Olson was one of the few economists to tackle the question of why autocracies provide good market-augmenting governance in some circumstances and not in others. In his last months, he was in the process of developing the notion that a market-augmenting, growth-promoting autocracy might evolve into a market-inhibiting, growth-deterring government. While it is certainly possible for an autocrat—or "stationary bandit"—to conduct economic policy in accordance with the encompassing interest of the society, this depends ultimately on his time horizon. If he expects a long rule, it is in his interest to conduct policies, and to create and

[15] See World Bank (1997, 152) for a standard definition of first- and second-generation reforms.

[16] See Gourevitch (1993).

maintain institutions, that serve to strengthen the economy and thus induce his subjects to engage in productive economic activity, while avoiding over-taxation of his subjects.[17]

Nevertheless, in comparing dictatorships and democracies, Olson finds two serious flaws in the former. First, one of the main features of market-augmenting government is the rule of law and, in particular, clearly defined and firmly enforced property rights. But without democracy, property rights are never entirely free of possible violation by an autocratic government—after all, even an exemplary autocratic government may be succeeded by a less exemplary one. And this brings us to the second problem of autocracy: it lacks mechanisms of orderly succession, and consequently, under autocracy, economic progress can be occasionally set back by succession crises that occur when an autocrat dies or is forcibly removed from power.[18]

In his last oral remarks on the East Asian Financial Crisis, Olson extended his analysis to include the possibility that autocrats long in power may themselves (or through their families) be drawn into rent-seeking activities. This is hardly original as an anecdotal observation—there is, after all, Lord Acton's famous (and often misquoted) statement that "power tends to corrupt, and absolute power corrupts absolutely"—but the motive for such corruption is ambiguous. At first glance, it might seem to be straightforward self-enrichment—that is, as the time horizon for the remainder of the autocrat's rule grows shorter, his strategy for self-enrichment shifts to one of short-term gains, behavior more typical of a roving than of a stationary bandit.

But the acquisition of economic assets may also be related to the succession problem, Olson's second major problem of autocracy. If the autocrat is concerned about maintaining himself or his own family in power, then extending family control over major economic entities is a likely strategy, since economic power can be a means of achieving or at least sharing in political power. Such a strategy would also explain the tendency of autocrats to seek direct control over economic activity through personal involvement in production or regulation, or such involvement by family members or close personal friends. Such a strategy runs counter to the standard prescription for market-oriented growth, which involves establishing an arm's-length relationship

[17] See Olson (1993), 567-76 and Olson (1996). See also Olson and McGuire (1996) for the argument that the optimum tax rate for an autocrat is at the point where the marginal cost of public goods provided through additional tax-financed government activity is equal to the marginal revenue, derived at the hypothesized tax rate, from the additional output induced by the additional public goods. It is further argued that in a democratically governed society, the optimum tax rate is likely to be regarded as lower than under an autocratic regime.

[18] See, again, Olson (1993). DeLong and Shleifer (1993) assert that, for example, the troubled history of succession in medieval and renaissance England would naturally have led the "princes" of that time to tax their subjects to the hilt and therefore discourage the growth of trade and manufacturing; it was not until the Glorious Revolution of 1688 that parliamentary supremacy was assured and British trade and manufacturing could "take off." While we do not find this interpretation of English history entirely convincing, to explain why would go far beyond the scope of this paper. Suffice it to say that in England, as in the Asian MSAs, one can find long episodes of "despotic" rule (actually rarely that despotic either in England or in most Asian countries) in which commerce flourished, for reasons both related and unrelated to government intervention.

between government and business: and by the 1980s this prescription, which underlies the "Washington consensus" of that period,[19] would have been well known to the technocrats involved in formulating economic policy in the East Asian countries.

Once this corollary, or extension, of Olson's analysis is accepted, some interesting conclusions follow.

1. To the extent that economic power is dispersed among the ruler's family and friends, the economic policy aims of the government also become dispersed. Perhaps, at first, the ruler gives control of some major state enterprise to a sibling or child or spouse, and the way in which that economic entity is run is in line with the encompassing interest as conceived by the ruler, with the help of his (or her) technocratic advisers. The autocrat may even be genuinely convinced that his/her family's control of the enterprise facilitates achievement of economic progress for the country. But eventually, the economic creature of the government takes on a life of its own, and its aims diverge from that of the encompassing interest. Little by little, as economic power is parceled out to family and friends, operation of each entity is pursued for the self-interest of the individual(s) in control: this, could, no doubt, be analyzed in terms of typical principal-agent problems (see Section IV). The network of relationships, including ties to the mechanisms of government, creates overwhelming temptations to self-enrichment by subordinates and associates through every conceivable form of favoritism and corruption. Thus, the evolution of a long-term ("stable") autocracy parallels that of a stable democracy as described by Olson in *The Rise and Decline of Nations*: the gradual accumulation and growing influence of particular interests, and a concomitant waning of the role played by the society's encompassing interest in the making of economic policy.
2. At the same time, the process just described tends to undermine the technocratic basis of economic decision-making, which was cited in *The East Asian Miracle*[20] as a reason for the superior performance of these countries since the 1960s. As considerations of the society's encompassing interest increasingly give way to the interests of the corporations and financial institutions run by the ruling family and its friends, the technocrats either find their views overridden by the political authority, or are themselves co-opted by those special interests through threat of losing their jobs or through financial incentives. Where there are, moreover, restrictions on freedom of the press and speech, even those technocrats who have not been corrupted have little scope for expressing their views, not to speak of organizing opposition to government policies.

[19] See Williamson (1993).

[20] World Bank (1993).

3. To some extent, the preceding analysis may also apply to the state's economic activities in a genuinely democratic setting, where the state has established state enterprises and state-run banks. Initially state-owned enterprises (SOEs) are created in order to facilitate encompassing national objectives like economic development, growth, and income stability. But eventually, the managements of the state enterprises create the kinds of special interest groups described by Olson in *The Rise and Decline of Nations*, and the encompassing interest gives way to economic policies geared to protecting particular sectors or industries.
4. Olson argued that even in those autocracies where a rule of law protects property rights in order to encourage market-oriented development, there is the threat of arbitrary seizure—if not by the current autocrat, then possibly by a successor. Thus, in the long run, democratically-based government, compared to autocracy, has a superior capacity to give individuals greater confidence in the enforcement of property rights. But it is instructive in this context to look at the broader framework of law provided by market-augmenting government, which entails not only enforcement of property rights but also enforcement of contracts, regulation of natural monopolies (and non-favoritistic auctioning of natural monopoly concessions, like use of frequencies in telecommunications), and regulations protecting the public against exploitation of labor or the environment. An Olsonian autocrat with a long time horizon could conceivably carry out these functions as well as a well-functioning democracy: but is this a likely outcome? Again, the long-term tendency for autocrats and their families and entourage to acquire economic power could be expected eventually to undermine the execution of a market-augmenting legal and regulatory framework under an autocratic regime. Regulations will tend not to be enforced when the autocrat's family businesses are involved; the judiciary will tend to settle contract disputes in favor of those politically best connected; and eminent domain will tend to be exercised arbitrarily when the autocrat's family and friends can benefit thereby. And this will tend to be more true, the longer the autocrat has been in power.

Of course, this stylized description of autocratic government fits some cases—like the Suharto era in Indonesia—better than others. In many countries, elements of democracy and autocracy are intermingled. In others, autocracies may be of special types: for example, where an autocrat comes to power through a military coup d'état and represents the military as such, rather than his own dynastic ambitions.[21] A military dictatorship can evolve toward personal

[21] As an interesting counter-example to Indonesia's Suharto, General Pinochet, perhaps not surprisingly in view of Chile's long democratic traditions, not only set the country in the right direction economically but also eventually transferred power to a democratically elected government. Pinochet's apparent lack of dynastic ambition may also be related to the relatively low level of personal "corruption" in the Pinochet regime: there was no political motive

dictatorship or towards a form of oligarchy, which is intermediate between autocracy and democracy. In an oligarchy, any individual's attempt to enrich himself or expand his power unduly would lead to his being unseated by the other members of the same group, *unless* the other oligarchs were given direct or indirect economic rewards.[22] One might expect that under such an arrangement, market-augmenting government would flourish, for example, if the wealthy supporters of the regimes are convinced that this approach will lead to their own enrichment. Some Asian countries with limited democracy may well be described as informal oligarchies rather than pure autocracies, and in some cases, were also able to spread economic benefits to a broad range of the population, thereby obtaining not only oligarchic but also popular support. This approach to market-augmenting government does not, however, eliminate the possibility of a long-ruling autocrat seeking extension of economic control for family and close associates.

An extreme case of the latter is provided by Indonesia's Suharto. And it is perhaps not a coincidence that Indonesia was the country suffering the greatest economic, social and political disruption from the financial crisis, once the credibility of the leadership was destroyed. Initially, the Indonesian military supported Suharto not because they saw him as a Napoleon-like ruler who would stay in power for more than three decades, but because they saw him as a representative of their group and savior of the country from chaos and Communism. Eventually, Suharto was able to transform this role into long-term power, avoiding removal by his military colleagues by sharing the economic pie with key individuals. But this was at the eventual expense of undermining the quality of macroeconomic, financial and corporate governance prevailing in the economic system (see Sections III and IV).

This analysis has only touched on some consequences of autocracy, although the complication of an oligarchy with democratic elements is also mentioned. In certain Asian countries of the latter type, "cronyism" developed through complex networks involving politicians, government officials, banks, and other businesses; in this networking, family and friendship relations undermined the impersonal calculations and transactions that characterize a true market system.[23] In some of these countries, however, countervailing tendencies have been

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to extend personal economic control. However, in the historically parallel case of the Argentinian military regime of l976-84, the military as a group took over a number of large enterprises in order to assure its own continued financing. This type of military involvement in the economy is, like the pure autocratic case, likely to lead both to massive inefficiency in the management of SOEs themselves and to undermining the central government functions of conducting prudent fiscal policy, ensuring efficient credit allocation by financial institutions, and maintaining arm's-length regulation of nonfinancial institutions. It may also lead to a kind of decentralized personal corruption, as individual managers of SOEs are tempted to use their positions for personal enrichment.

[22] As Tanzi (1995, 1998) has pointed out, government power may be employed for the benefit of various groups included in the social network of leaders and officials: "...the abuse of public power is not necessarily for one's private benefit but for the benefit of one's party, class, tribe, friends, family, and so on." (Tanzi, 1998, 564)

[23] A description and analysis of these networks can be found, for instance, in Landa and Yong (1998).

substantial: for instance, the gradual strengthening of democracy in Korea resulted in the election of a President determined to reduce the monopoly power of the chaebols. Such cases, however, may be qualified by path dependencies. For instance, a democracy that until recently had strong autocratic elements—as in Korea—may still suffer from inadequately developed supporting institutions, thereby allowing elements of the former leadership to hold on to some degree of their former economic and political power.

To what extent "cronyism" and other forms of favoritism and corruption affecting economic decision making can arise in countries with overtly democratic institutions, and how these phenomena can be measured and compared across countries and time periods, requires further research. One might hypothesize that in countries with a strong executive and relatively weak checks and balances from the legislature or civil society, cronyism and corruption have tended to flourish, and that this pattern might be expected to be especially strong where one chief executive (e.g., Suharto) or one party (e.g., the ruling party in Malaysia) holds power for a long period of time. This pattern would, of course, be consistent with the model of autocracy outlined earlier. Another type of development consistent with democratic institutions is a heavy degree of government intervention in the economy, with state ownership of banks, public utilities, and manufacturing corporations; this, too, can breed cronyism and the temptation for politicians and government officials to enrich themselves illegally. Nevertheless, in a truly democratic society, these scandals will eventually come to light—e.g., as in France in recent years.

Finally, to return to the evolutionary model suggested in sub-sections II.1 and II.2, it appears that development of more sophisticated financial markets, accompanied by integration into the global economy, strengthens the case not only for a more arm's-length approach to economic governance but also for democratization. This is partly because autocracy tends, over the long haul, to favor a discretionary approach to government economic policy and resistance to creating a level playing field for all market participants. But it is also because, as will be argued in Section IV, the types of financial and corporate governance which foster a properly functioning market economy require degrees of transparency and accountability that are more likely to be found in a democratic environment than under an autocratic regime.

## III. Macroeconomic Governance

By "macroeconomic governance," we mean the political and administrative processes by which macroeconomic policies are formulated, implemented, and evaluated. From a purely technical standpoint, the same policies can be carried out with equal effectiveness by either an autocratic or a democratic government. Indeed, as already noted, officials in international financial institutions tended for many years to suppose that autocrats, if supported by well-trained technocrats, were likely to come up with first-class macroeconomic governance, in part because they could avert the Olsonian collective-action problems arising from special interests in established democracies. Nevertheless, there may be factors that over time lead to deterioration in the quality of these policies in an autocracy, as well as problems in the ability of such governments to adjust policies in response to changes in economic circumstances.

In the international financial community, there was great faith in the local technocrats in the East Asian countries, who were by and large quite competent, and rightly stressed conservative fiscal and monetary policies. Prior to the boom, all the most seriously affected countries had participated in the "East Asia Miracle." All participated in the global economy and all had had to deal with the mixed blessing of large-scale capital inflows, which grew to especially high levels in the late 1980s and early 1990s.

Despite their excellent track record up to 1997, there is broad consensus among economists that Indonesia and Thailand, perhaps also Korea, hung on too long to what had become overvalued exchange rates, that all experienced inflated property and stock prices, that all had poorly-regulated and -supervised financial and corporate systems, and that areas of non-transparency in both official and private financial dealings indirectly exacerbated the crisis when unfortunately timed "revelations" occurred. In particular, all had depended on large-scale direct investment from, and trade with, Japan, thereby suffering over the past few years from the twin problem of an appreciating dollar (to which all their currencies were pegged) and a stagnating Japanese economy. The decision to stick with a fixed exchange rate was fatal, although understandable in view of the great desire for stability and maintaining policy credibility. Less sympathetically must one view the unwillingness to submit financial institutions to stricter and more impartial regulation, especially in the face of liberalizations of both financial markets and the capital account of the balance of payments.[24] Both exchange rate and regulatory policies ran against the best international advice, offered both long ago and recently.

The growing problems with macroeconomic policies in these countries were therefore fairly clear. Why nothing was done about them is the more interesting issue. Perhaps the givers of advice pressed less hard than they might have because they shared the widespread belief that the Asians "knew better," that the "Asian way" or "Asian model" (sometimes "Japanese model") was superior. It is not clear to what extent those international civil servants (notably in the World Bank and IMF) responsible for dealing with the technocrats in the MSAs perceived and communicated these problems to the authorities. However, the Mexican crisis of 1994-95, and the literature

[24] See Krugman (1998).

growing out of it, gave plenty of advance warning of the dangers posed by large capital inflows, fixed exchange rates, poorly supervised banking systems, and volatile international capital markets.  It seems unlikely that at least some of the technocrats—both domestic and international—were not aware of these problems. The fact that little or no action was taken—for example, that relatively huge foreign liabilities of banks and corporations were allowed to develop—suggests ulterior motives on the part of the political authorities.

In particular, the inflexibility of macroeconomic policies may be accounted for by the particular interests of banks and corporations owned by family or friends of the head of the government. This seems to have been especially true in Indonesia, where the bizarre attempt to establish a currency board in early 1998, at a time when no one knew what an equilibrium exchange rate for the rupiah might be, was seemingly intended to protect the interests of those with large foreign liabilities. Such policies might also indicate that the high-level human capital required for effective macroeconomic policies, and the incentives to give objective advice to the political leadership, were less well-developed in Indonesia than in, say, Korea and Thailand.

A broader question, for both autocracies and democracies, is how to organize macroeconomic governance in a way that is technically competent, coordinated, sensitive to international developments relevant to the home country, and accountable to the political authority. Another broad question is whether the nature of political governance matters in this regard: witness the contrast between the once fashionable notion that authoritarian governments may be more effective in "getting the job done" in the macroeconomic realm, and the current, equally fashionable notion, that democratic governance may after all work better in dealing with a major macroeconomic crisis. Both these questions require deeper study than can be given here, but the following considerations seem relevant.

One might first note that for historical reasons, and with some administrative justification, there is a tendency to divide up the responsibility for macroeconomic governance along sectoral lines: the central bank deals with the banking/monetary/financial sector; the ministry of finance (or treasury) with fiscal management, although the latter responsibility is sometimes split (like in Mexico) between the revenue collection (and borrowing) side (Ministerio de Hacienda) and budgetary side (Ministerio de Presupuesto y Planeación), or like in the U.S. between a Treasury and a budgeting agency (Office of Management and Budget); a ministry or agency devoted to international trade agreements and policies (usually coordinated with the Ministry of Finance, which collects customs tariffs); and other ministries with responsibilities for foreign affairs that negotiate international agreements with budgetary, monetary or macroeconomic implications.

In countries with autocratic rule or only partial democracy, the formulation and implementation of budgets is fraught with opportunities for poor governance. While in the first instance, channeling funds to pet projects and favored enterprises can be regarded primarily as a source of microeconomic distortion, in the long run such practices take on macroeconomic dimensions, as certain types of expenditures become quasi-entitlements, and fiscal deficits develop because of excessive outlays of this type. This is why it is especially important to install politically independent auditing and program evaluation units, separate from the budgeting ministry or agency itself. In practice, however, it would be naive to expect such units to do their job properly, and truly independent of interference from the executive, without the types of safeguards normally found in democratic societies: a popularly elected legislature; freedom of speech, press and assembly; and freedom for NGOs to organize and operate. Many would add to these points: the rule of law, enforced by an independent, impartial, and competent judiciary.

A key factor in the effectiveness and accountability of macroeconomic policy—and, by implication here, its independence from special interests—is the degree of independence of the central bank. A relatively depoliticized and independent central bank can be a highly effective mean of keeping a country on a stable macroeconomic track—although the latter cannot be accomplished without a responsible fiscal policy, which requires political support.

Further, successful macroeconomic policies require coordination among the agencies responsible for their formulation and implementation. Such coordination requires the existence, somewhere in the government, of a small, highly qualified group of economic analysts who provide a comprehensive view of how monetary, fiscal and external economic policies are linked together in an economic package. In some countries, such a coordinated view comes chiefly from the central bank, which tends to have better qualified (because better paid) staff than the government ministries. In other countries, there is a policy group of advisors in the Ministry of Finance, or, where it exists, the Ministry of Economics, or the Planning Ministry or Agency. Yet another model is to have a special unit attached directly to the Presidential Office, which can serve as a secretariat to a sort of economic cabinet (like the National Economic Council in the U.S.). Further support might come from a Council of Economic Advisors, like in the U.S. or Germany.

One need not be dogmatic about which modality of macroeconomic coordination works best, as this depends on the institutional and political setting, and on available human resources. For example, where skilled human resources are sufficiently plentiful, having two poles of policy coordination, both in the central bank and in the ministry of finance (or planning, or budget) can work quite well, under strong and properly motivated political leadership. Likewise, in a parliamentary system, where a coordinating policy mechanism in the cabinet already exists, and in countries where skilled personnel are plentiful, a relatively fragmented system of policymaking units in different government entities may actually work better than concentrating the coordinating power in the office of a president or prime minister.

Coordinating mechanisms can obtain useful support from a strong legislature, with specialized committees (backed by their own, independent, and well-qualified staffs) focusing on budgetary management, tax policy, and overall economic policy. While legislatures often also serve as conduits for the views of special interests, this is at least done under public scrutiny; and legislatures with more than rubber-stamp powers to shape budgets and economic policies can effectively check any tendencies in an autocratic executive to use political power for the benefit of private economic interests. Independent oversight of executive policies is, of course, greatly strengthened by a truly independent and legally protected civil society and a free press.

International influences—like the IMF, World Bank, and regional development banks—can also be helpful in galvanizing and improving faulty coordinating mechanisms, as well as bringing pressure to bear on those responsible to follow correct policies. But their influence is necessarily limited in a world of sovereign nation-states. This topic will be discussed further in Section V.

Alternatively, where an autocrat (or strong, democratically elected executive with weak checks and balances) prevails, one would expect the coordination of macroeconomic policy to be controlled directly by the ruler and his immediate staff, and one would not expect to see a truly independent central bank or autonomous coordinating agencies, councils, or think-tanks. Of course, it is as true for this kind of regime as for others that effective coordination of policies is necessary: it is quite possible for autocracies to be badly run (there are numerous examples in Africa and Latin America). But even compared with a relatively efficient autocracy, and assuming comparable circumstances (per capita income, education levels), one would expect that in a democracy with checks and balances, and with reasonably effective policy coordination, the quality of macroeconomic advice coming to the chief executive would be superior to that of the advice arising from a top-down, manipulated process of policy formation. Wise autocrats have sought expert, disinterested advice. But the dangers of such advice being tarnished by corrupting political processes are greater in an autocracy than in a democracy, and, for reasons explained in Section II, tend to become greater the longer the autocracy has been in power.

## IV. Financial and Corporate Governance

It is hardly news these days that the way in which financial institutions are run, including their supervision and regulation, has much to do with the economic success of a country. This is true for both obvious and less obvious reasons. It is obvious that when financial institutions are operated imprudently, they lead to periodic financial crashes; the resulting boom-bust cycle creates economic insecurity, especially for the poor, and also an investment climate that over the long run may lead to slower growth than in a more stable environment. Among the less obvious implications of proper management of the financial sector is that when credit is available to all potential entrepreneurs—not just the rich and well-connected but also the new, small businessmen—economies tend to acquire a more buoyant growth dynamic.

The topic of corporate governance, which has received special attention since the beginning of the Asian crisis, is so closely related to financial governance in these (and in many other countries) that it seems useful to discuss these topics together. Moreover, financial and nonfinancial corporations tend to be subject to a similar structure of governance—from creditors, shareholders and markets. And the governance of both types of organization is closely linked to the nature of the political regime and its mode of intervention in the economy.

In the U.S., nonfinancial and financial corporations apparently exist in different worlds, sharply separated by function and by law. One might forget that this was not the case before the legal separation of such institutions was carried out through the "trust-busting" legislation of the Progressive Era. While this trust-busting was motivated by different considerations than those related to the Asian financial crisis, it reminds us that the close linkage between financial power and the nonfinancial sectors may both serve useful purposes in earlier stages of economic development and create dangers at later stages. These dangers may be especially great when there is a close relationship between economic and political power, and it was, in fact, the perception of such a nexus in the United States that led to public enthusiasm for trust-busting.

## 1. Definition of governance.

The working definition of governance used here depends on the key distinction between principals and agents. Most economic entities are operated by agents, not principals, but even principal-operated entities are in some respects carrying out the functions of agents. For example, the daily operations of all but small firms are typically carried out by managers who are not the main owners; at the same time, most firms borrow money from lenders whose objectives are different from those of borrowers.

In this context, governance is defined as the legal and institutional arrangements governing the behavior of an economic entity, by which owners, creditors, markets and the government compel or induce agents to behave according to the interests of the principals, or those of the broader society. In the following discussion, two key elements of governance are discussed. First, there is the structure of incentives and rules facing agents with regard to such matters as granting and terminating lending, bankruptcy, the rights of boards of directors, compensation structure, and the termination of employment. Second, there is the structure of the information flow from agents to principals, that is, the rules and incentives affecting accountability, transparency and disclosure of information. In both cases, the government plays a key role in setting the rules by which private actors operate.

## 2. Sources of governance

There are five main channels through which corporate and financial governance operate.

*(1) Governance by creditors*

In a typical loan contract, failure of the debtor to service a loan and repay the principal allows creditors to force the debtor either to pay or declare bankruptcy. Bankruptcy is therefore a key element of governance imposed by creditors and has the economic effect of preventing inefficient over-investment. The loan selection process provides another important governance mechanism, determining the granting, renewal or termination of loans based, ideally, on a careful evaluation of each borrower and project. Improper functioning of these mechanisms intensifies problems of moral hazard and adverse selection and tends to result in over-investment. Suppose that firms failing to service loans could avoid bankruptcy and that loans were granted according to criteria other than profitability and riskiness—for instance, by discretionary government intervention. In such cases, one would expect to observe over-investment and the accumulation of non-performing loans. These phenomena were, in fact, observed in the Asian MSAs.

It follows that the positive contribution of the financial sector to governance of the nonfinancial sector is determined at least in part by the quality of political governance. Thus, if the government interferes with loan allocation decisions to favor particular firms, governance by creditors can not function as intended. When the selection of loan recipients is based not on economic fundamentals but on ad hoc criteria imposed by the government, favoritism is fostered; and, to make matters worse, when favored firms fail to service loans, the government will tend to take measures—bailouts, subsidies, etc.—to help these firms avoid bankruptcy. By the same token, the government may avoid setting up proper bankruptcy procedures, in order to restrict the range of non-discretionary decision-making within the economic system.

Finally, the government's direct involvement in loan allocation tends to hamper the orderly development of human capital in financial institutions, i.e., the capacity of the staff of those institutions to evaluate, thoroughly and objectively, the expected returns and riskiness of projects proposed in loan applications, as well as the track record of the borrowers. Developing such capacity is an excellent example of "learning by doing," and all the MBA courses in the world will not develop this capacity unless the financial system operates in such a way that officers of financial institutions are given the incentives to carry out these functions properly, that is, accountability (both positive and negative) based on a profit function that factors in the risk element. If the government directs loan allocations, and bails out both financial and nonfinancial corporations that encounter difficulties as the result of poor, politically motivated decisions, such incentives are, at best, weak.

*(2) Governance by owners*

For corporations, there are typically two main sources of principal-agent problems: the separation of management from ownership, and management by a key owner who owns only a small fraction of total shares. In the first case, the problem is to restrict empire-building and improper personal enrichment by professional managers (a particularly acute problem in Soviet and post-Soviet economies); in the second case, the problem is how to restrict expropriation of minority shareholders by the key owner(s). Of these two problems, management of firms by key owners is reported to be the more common.[25]

The usual mechanisms to deal with these principal-agent problems are boards of directors, an incentive-based compensation structure for managers, the stock market, and the market for corporate control. The first two mechanisms operate directly on the internal governance of a firm. The stock market exercises indirect governance through the continual evaluation of performance implicit in stock price adjustments, which effectively provide the market with information about that evaluation. Various legal and institutional arrangements can be set up to facilitate shareholder control and protect against abuse by insiders: for instance, the right to call emergency shareholder meetings, penalties for insider trading, and mandatory disclosure of financial and non-financial information. Related to the stock market is the market for corporate control, that is, the existence of potential buyers who can take over and restructure a firm (including dismissal of managers) when the firm is performing under its potential.

SOEs create special problems of corporate governance. Even in a democratic setting, and in a largely market-oriented economy, privatization strengthens governance by owners, because private owners are much more active in checking management than is the government. In an autocratic setting, the potential evils of SOEs are much greater. SOEs provide great opportunities for direct government intervention in the economy as a means for securing the power of the regime: for instance, by providing key positions for placing members of the autocrat's family and allies. In the worst case, SOEs can become part of a network of government-directed credits and investments, squeezing out non-favored private enterprises and thereby weakening the influence of

[25] LaPorta, Lopez-de-Silanes, and Shleifer (1998).

market-determined allocation of resources.  In this case, while the power and political support of the regime are ostensibly strengthened, macroeconomic governance tends to be undermined.[26]

*(3) Government regulation*

When the incentives of financial institutions and nonfinancial corporations deviate from those that lead to socially desirable results, the government may intervene so as to compel or induce these entities to behave in more socially desirable ways.  Such regulation may range from environmental regulations to prudential regulation of financial institutions.  Since the type of regulation most relevant to the Asian financial crisis is prudential regulation of financial institutions, we will focus on the latter.

There are several reasons why governments might wish to impose relatively stringent regulations on financial institutions, as opposed to other kinds of businesses.  In part, it is to ensure the stability of the financial sector, to which a large part of the nonfinancial economy is linked. Moreover, regulation is necessary because the government, as lender of last resort, must be concerned with moral hazard and adverse selection problems.  Information problems are particularly acute in financial markets because financial transactions take place over time, therefore involving more uncertainty and riskiness than the (usually) shorter-term trade of goods and services.  Since financial institutions have limited liability and usually operate under a partly explicit (e.g., deposit insurance) and partly implicit guarantees, they may be tempted to reckon on capturing upside potential gains while keeping the downside limited to the amount of their net worth, and so may tend to undertake riskier lending and lower capitalization than the public interest would dictate.  To deal with these problems, governments impose capitalization and risk-taking guidelines on financial institutions.  Over-guaranteed and under-regulated intermediaries have been blamed—e.g., by Krugman and the IMF[27]—as a major cause of the Asian financial crisis.  Related explanations—such as Radelet and Sachs' (1998) emphasis on the accumulation of short-term foreign currency borrowing—may also be ultimately linked to the weakness of government regulation of the financial system.

The key elements of effective banking legislation and prudential regulation are contained in the Basle Committee's *Core Principles for Effective Banking Supervision*.[28]  First, capital adequacy ratios should ensure that banks maintain a minimum amount of capital to absorb

[26] For elaboration of these problems see World Bank (1995).  The possible need for SOEs, as one form of direct government intervention at an early stage of development, is mentioned in Section II.  Moreover, as explained in the World Bank report just cited, and elsewhere, mechanisms can be devised to create rules and incentives such that SOEs are run efficiently.  But such rules and incentives are more likely to be established and properly implemented in a democratic setting, with public oversight, than in an autocratic regime.

[27] Krugman (1998); IMF (1997b, 1998a), as well as other IMF publications.

[28] Reproduced in Folkerts-Landau and Lindgren (1998), and discussed in detail in Goldstein (1997).

unanticipated losses and that managers and owners have incentives to operate banks safely.[29] Second, risk should be diversified, avoiding excessive lending to a single borrower, connected group of borrowers, or sector of the economy. Third, supervisory authorities must have sufficient autonomy, authority and capacity. With regard to capacity, supervisory agencies need to attract and retain employees of high skill and provide them with ongoing training to keep pace with the growing sophistication of financial sector activities.

Effective government regulation of financial institutions depends on the principle of preserving an arm's-length relationship between the government and the financial system. When government becomes directly involved in loan allocations, or state-owned banks engage in operations dictated by the state of the government's finances rather than the banks' own business interests, it may be impossible to properly enforce a system of prudential regulation. There is thus some tendency for countries with authoritarian, nontransparent political governance to perform poorly in the field of prudential regulation of financial institutions, although even in more democratic political systems problems may also arise in the context of a large state-owned share in the banking system.

*(4) Market competition*

Market competition puts managers of both financial and nonfinancial corporations under continual pressure to minimize costs and to innovate. Furthermore, market competition renders measures of performance, such as profitability, more informative than when there is a lack of competition. In the latter instance, market power can make firms financially successful even in the face of poor investment decisions and resource allocation. Some of the policy conditions in IMF programs for the Asian MSAs—import liberalization, anti-trust policy, and allowing foreign banks to enter the domestic market—were intended to improve corporate governance through promoting competition, although these measures were sometimes criticized as imposing the interests of major IMF shareholders (U.S., Japan) on the program countries.

*(5) Internal organization*

The structure within an organization also helps determine the quality of governance. Making managers more accountable for a firm's performance and providing checks and balances within an organization would strengthen internal governance. In this case, outside monitoring—by a board of directors or an outside accountant—lowers the chance that a manager at any level can hide poor performance by non-reporting of information. While management consultants and

[29] IMF (1998a), 74-75.

business schools throughout the world have developed models and techniques of effective internal corporate management, there are still quite large international and interfirm differences—in part cultural, in part individual—among the safeguards used to ensure good internal governance of enterprises.

## 3. Corporate and financial governance in East Asia

Is there evidence to suggest that a financial crisis is more likely to occur in countries with relatively weak corporate and financial governance? Johnson et al. (1998) provided empirical evidence that governance was more important than macroeconomic conditions in explaining the extent of financial crisis in the East Asian Crisis. Using data of 25 emerging markets, they show that measures of corporate governance, particularly the effectiveness of protection for minority shareholders, explain the extent of depreciation and stock market performance better than macroeconomic measures. Instead of conducting regression analysis on data from a handful of countries, this section presents data for several measures of corporate and financial governance, which clearly indicate MSAs have weak corporate and financial governance.

*(1) Governance by creditors and owners*

The most recent World Development Report[30] assesses the legal infrastructure for creditors' and shareholders' rights for more than 50 countries (Table 1). Interestingly, MSAs generally receive a low score for shareholders' rights and especially for law enforcement, suggesting that lack of enforcement was an especially serious problem. The World Competitiveness Yearbook 1998,[31] based on subjective evaluations by foreign investors, reports a similar pattern: MSAs scored very low in the effectiveness of corporate boards to prevent improper practices and in the protection of the rights and responsibilities of shareholders.

Another World Bank report[32] provides a more detailed and objective measure for governance by creditors and owners. It reports that the most severely affected countries have relatively poor protection of shareholder rights. Indonesia, Thailand and Korea receive 1 or 2 for anti-director rights, while Singapore, Hong Kong, Japan and the U.S. scored 4 or 5 (Table 2). For creditor rights, the MSAs score as high as other countries (Table 3). In this case, too, the problem seems to be less a problem of laws on the books than one of poor enforcement.

*(2) Government regulation*

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[30] World Bank (1998b).

[31] IMD International (1998).

[32] World Bank (1998d).

How well were financial institutions regulated in the MSAs? Did they perform worse than other countries? The World Competitiveness Yearbook 1998 ranks Korea, Indonesia and Thailand among the worst 5 countries in terms of legal regulation and financial institutions. To some extent, this ranking simply represents hindsight, but the pre-crisis (1996) ranking still gives the three countries mediocre rankings: 42nd, 33rd, and 23rd out of 46 countries, respectively.

## Table 1. Assessment of legal infrastructure

| Country | Creditors' rights | Shareholders' rights | Enforcement | Origin of legal systems |
|---|---|---|---|---|
| Indonesia | 1 | 2 | 5.04 | French |
| Thailand | 1 | 3 | 6.91 | English |
| Korea | 1 | 2 | 6.97 | German |
| Malaysia | 1 | 3 | 7.11 | English |
| Philippines | -2 | 4 | 3.77 | French |
| Taiwan | 0 | 3 | 8.84 | German |
| Singapore | 1 | 3 | 8.72 | English |
| Hong Kong | 1 | 4 | 8.52 | English |
| Japan | 0 | 3 | 9.34 | German |
| USA | -1 | 5 | 9.50 | English |
| Sample average for 49 countries | -0.27 | 2.45 | 7.21 | |

Sources: Knowledge for Development. The World Bank World Development Report 1998/1999

Note: Scores for creditors' rights range from –2 to 1; scores for shareholders' rights range from 1 to 5; values for enforcement range from 1 to 10.

## Table 2. Shareholders' Rights

| Country | One share one vote | Proxy by mail allowed | Not blocked before meeting | Cumulative voting/ proportional represntn. | % of share to call an extra meeting | Pre-emptive right to new issues | Oppressed Minority | Anti-director rights |
|---|---|---|---|---|---|---|---|---|
| Indonesia | 0 | 0 | 1 | 0 | 0.10 | 0 | 0 | 2 |
| Thailand | 0 | 0 | 1 | 1 | 0.20 | 0 | 0 | 2 |
| Korea, Rep of | 1 | 0 | 0 | 0 | 0.05 | 0 | 1 | 2 |
| Malaysia | 1 | 0 | 1 | 0 | 0.10 | 1 | 1 | 4 |
| Philippines | 0 | 0 | 1 | 1 | open | 0 | 1 | 3 |
| Taiwan, China | 0 | 0 | 0 | 1 | 0.03 | 0 | 1 | 3 |
| Hong Kong | 0 | 1 | 1 | 0 | 0.10 | 1 | 1 | 5 |
| Singapore | 1 | 0 | 1 | 0 | 0.10 | 1 | 1 | 4 |
| Japan | 1 | 0 | 1 | 1 | 0.03 | 0 | 1 | 4 |
| United States | 0 | 1 | 1 | 1 | 0.10 | 0 | 1 | 5 |
| Sample average (50 countries) | 0.22 | 0.18 | 0.71 | 0.27 | 0.11 | 0.53 | 0.53 | 3 |

Sources: Beyond the Washington Consensus: Institutions Matter. World Bank Latin American and Caribbean Studies, 1998.

Definitions:

**(1) One share-one vote:** Equals 1 if the Company Law or Commercial Code of the country requires that ordinary shares carry one vote per share, and zero otherwise. Equivalently, this variable equals 1 when the law prohibits the existence of both multiple-voting and non-voting ordinary shares and does not allow firms to set a maximum number of votes per shareholder irrespective of the number of shares owned, and 0 otherwise.

**(2) Proxy by mail allowed:** Equals 1 if the Company Law or Commercial Code allows shareholders to mail their proxy vote to the firm, and 0 otherwise.

**(3) Not Blocked before meeting:** Equals 1 if the Company Law or Commercial Code allows shareholders to require that shareholders deposits their shares prior to a General Shareholders Meeting thus preventing them from selling those shares for a number of days, and 0 otherwise.

**(4) Cumulative voting:** Equals 1 if the Company Law or Commercial Code allows shareholders to cast all of their votes for one candidate standing for election to the board of directors (cumulative voting) or if the Company Law or Commercial Code allows a mechanism of proportional representation in the board by which minority interests may name a proportional number of directors to the board, and 0 otherwise

**(5) Percent of share to call an extra meeting:** It is minimum percentage of ownership of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting. It ranges from 1 to 33 percent.

**(6) Preemptive right to new issues:** Equals 1 when the company Law or Commercial Code grants shareholders the first opportunity to buy new issues of stock and this right can only be waved by a shareholders' vote, and 0 otherwise.

**(7) Oppressed minority:** Equals 1 if the Company law or Commercial Code grants minority shareholders either a judicial venue to challenge the decisions of management or of the assembly or the right to step out of the company by requiring the company to purchase their shares when they object to certain fundamental changes, such as mergers, assets, dispositions, and changes in the articles of incorporation. The variable equals 0 otherwise. Minority shareholders are defined as those shareholders who own 10 percent of share capital or less.

**(8) Anti-director rights:** An index aggregating the shareholder rights, which we labeled as "anti-director rights." The index is formed by adding 1 when: (1) the country allows shareholders to mail their proxy vote to the firm; (2) shareholders are not required to deposit their shares prior to the General Shareholders' Meeting; (3) cumulative voting or proportional representation of minorities in the board of directors is allowed; (4) an oppressed minorities mechanism is in place; (5) the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting is less than or equal to 10 percent (the sample median); or (6) shareholders have preemptive rights that can only be waived by a shareholders' vote. The index ranges from 0 to 6.

# Table 3. Creditor Rights

| Country | Restrictions for going into reorganization | No automatic stay on assets | Secured creditors first paid | Management does not stay in reorganization | Creditor rights |
|---|---|---|---|---|---|
| Indonesia | 1 | 1 | 1 | 1 | 4 |
| Thailand | 0 | 1 | 1 | 1 | 3 |
| Korea, Rep of | 0 | 1 | 1 | 1 | 3 |
| Malaysia | 1 | 1 | 1 | 1 | 4 |
| Philippines | 0 | 0 | 0 | 0 | 0 |
| Taiwan, China | 0 | 1 | 1 | 0 | 2 |
| Hong Kong | 1 | 1 | 1 | 1 | 4 |
| Singapore | 1 | 1 | 1 | 1 | 4 |
| Japan | 0 | 0 | 1 | 1 | 2 |
| United States | 0 | 0 | 1 | 0 | 1 |
| Sample average (50 countries) | 0.55 | 0.49 | 0.81 | 0.45 | 2.30 |

Sources: Beyond the Washington Consensus: Institutions Matter. World Bank Latin American and Caribbean Studies, 1998.

Definitions:

**(1)** **Restrictions for going into reorganization:** Equals 1 if the reorganization procedure imposes restrictions, such as creditors' consent, to file for reorganization. It equals 0 if there are no such restrictions.

**(2)** **No automatic stay on assets:** Equals 1 if the reorganization procedure does not impose an automatic stay on the assets of the firm upon filing the reorganization petition. Automatic stay prevents secured creditors to gain possession of their security. It equals 0 if such restriction does not exist in the law.

**(3)** **Secured Creditors first paid:** Equals 1 if secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm. Equals 0 if non-secured creditors, such as the government and workers, are given absolute priority.

**(4)** **Management does not stay in reorganization:** Equals 1 when an official appointed by the court, or by the creditors, is responsible for the operation of the business during reorganization. Equivalency, this variable equals 1 if the debtor does not keep the administration of its property pending the resolution of the reorganization process, and 0 otherwise.

**(5)** **Creditor rights:** An index aggregating different creditor rights. The index is formed by adding 1 when: (1) the country imposes restrictions, such as creditors' consent or minimum dividends to file for reorganization; (2) secured creditors are able to gain possession of their security once the reorganization petition has been approved (no automatic stay); (3) secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm; and (4) the debtor does not retain the administration of its property pending the resolution of the reorganization. The index ranges from 0 to 4.

*(3) Market competition*

Table 4 presents proxies for competition among nonfinancial companies: the number of listed firms per 1 million population and a trade openness measure. The MSAs tend to have a smaller number of listed firms, suggesting that weak competition in goods markets is related to the occurrence of a financial crisis. A problem in interpreting this data is that it may show not only the degree of market competition but also the availability of business information, since listed firms would tend to face a stronger information disclosure requirement than non-listed firms.

**Table 4. Output Market Competition**

**Domestic firms / Population:** Ratio of the number of domestic firms listed in a given country to its population (in millions) in 1994.

| Country | Domestic firms/pop | Years open |
|---|---|---|
| Indonesia | 1.15 | 0.56 |
| Thailand | 6.70 | 1.00 |
| Korea, Rep of | 15.88 | 0.60 |
| Philippines | 2.90 | 0.78 |
| Malaysia | 25.15 | 1.00 |
| Taiwan, China | 14.22 | 0.71 |
| Hong Kong | 88.16 | 1.00 |
| Singapore | 80.00 | 1.00 |
| Japan | 17.78 | 0.73 |
| United States | 30.11 | 1.00 |

Sources:
* Domestic firms / pop from Beyond the Washington Consensus: Institutions Matter. World Bank Latin American and Caribbean Studies, 1998.
* Years open from Sachs and Warner, Economic Reform and the Process of Global Integration, *Brookings Papers on Economic Activity*; 0(1), 1995, pages 1-95.

## 4. Restructuring in most severely affected countries

The data reported in the previous section suggests that the MSAs have generally had poor corporate and financial governance. One might ask whether measures taken to strengthen such governance since the onset of the crisis have been more effective in some countries than in others, and whether responsiveness to the crisis itself reflects the quality of political governance. Although it is too early to tell how effective these measures (summarized in Appendix 1) will turn out to be, it may be useful to briefly review them. There is some indication that the stronger democratic base in Korea and Thailand has produced a more effective response than in Indonesia, hampered by continued autocratic rule until May 1998, and by political uncertainties and social instability since then.[33]

*(1) Governance by creditors*

All three MSA countries have overhauled their bankruptcy systems and adopted workout procedures for insolvent corporations and banks. Indonesia has overhauled its bankruptcy system by introducing procedural rules to ensure certainty and transparency, and to provide greater protection against insider and fraudulent transactions. For effective enforcement, Indonesia has also introduced a Special Commercial Court that will have jurisdiction over bankruptcy proceedings.[34] Thailand is expected to pass a strengthened bankruptcy law.[35] Korea is also working on improving bankruptcy procedures and will submit the draft to the National Assembly by February 1999.[36] This having been said, experience in Indonesia thus far has shown that bankruptcy laws alone do not change the business environment overnight: bankruptcy courts are inadequate in number and trained personnel have thus far dealt with only a handful of the thousands of bankruptcy cases pending.[37]

Interestingly, Thailand is also working on overhauling secured lending laws from expanding collateral assets to strengthening security rights. Secured lending, compared to unsecured lending, provides a better incentive (less moral hazard) to borrowers and a better screening device (less adverse selection) for creditors, because collateral implies a higher bankruptcy cost for borrowers. Therefore, strengthening commercial registries would lead to financial deepening and a more efficient allocation of funds.

*(2) Governance by owners*

Privatization is included in all the restructuring plans of the three countries. The Indonesian government plans to divest its shares in some of the large state enterprises within the 1998 fiscal year and will identify seven new enterprises for privatization. Thailand has prepared a privatization action plan and developed a legal framework for privatization that includes a regulatory framework and new corporatization law. The Korean government has announced immediate privatization of 5 SOEs and their 21 subsidiaries, and gradual privatization, by 2002, of 6 other SOEs.

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[33] Stiglitz has argued that autocratic regimes may be more successful steering economies in good times than in responding quickly and effectively to economic crises. See Stiglitz (1998).

[34] Indonesia Letter of Intent with the IMF, April 10, 1998. See also Lane et al. (1999).

[35] Thailand Letter of Intent with the IMF, December 1, 1998. See also Lane et al. (1999).

[36] Korea Letter of Intent with the IMF, July 24, 1998. See also Lane et al. (1999).

[37] Radelet and Sachs (1999); and talk by Steven Radelet at USAID, Washington, D.C., January 7, 1999.

In Korea several measures to strengthen the accountability of boards of directors have been taken, such as introducing a requirement that there be outsiders on board. To better protect the small shareholder, the Korean government has allowed cumulative voting and the possibility of class action suits against a corporation's executives and its auditors. Also, there will be a separation of the evaluation function from the executive function of boards of directors, thereby providing stronger governance of managers.

All three MSAs are enacting laws requiring mandatory regular disclosure of financial and non-financial information according to international accounting standards. Interestingly, the role of the Korean Institute of Certified Public Accountants (KICPA), which is a non-governmental organization, is being strengthened for the purpose of providing accounting standards according to international best practices.

*(3) Government prudential regulation*

Since the onset of the crisis, the Asian MSAs have begun to deal with two problems associated with financial governance: excessive government guarantees to, and deficient regulation of, financial institutions. The main benefit of allowing the closure of non-viable banks is the strengthening of governance over financial institutions by introducing the possibility that banks can fail, though the desirability of this approach in the middle of a financial crisis has been controversial.[38] Appendix 1 indicates the number of banks closed since the onset of the crisis; those numbers are especially high in Thailand, where 53 out of all 142 banks were closed.

All three MSAs have begun to improve the regulatory and supervisory framework for financial institutions. Improvements have been made in the standards for capital adequacy and loan classifications, while the independence of supervisory agencies has been strengthened, disclosure requirements have been made more stringent, and the responsibilities and duties of managers of financial institutions, as well as the role of outside investors, have been increased.[39]

*(4) Competition in goods markets*

All three countries have committed themselves to take measures to increase the external openness of their economies, by undertaking, inter alia, tariff reductions, by phasing out quota restrictions and by opening more markets to foreigners. Indonesia has also been taken several steps to increase domestic competition, such as abolition of the monopoly of BULOG and elimination of provincial and local export taxes. One interesting reform implemented in Korea is forcing each chaebol to focus on its chief products by selling other parts of their business to other chaebols. The effectiveness of this so-called "Big Deal" is critically dependent on foreign trade

[38] For instance, see Radelet and Sachs (1998).

[39] See World Bank (1998a), 41, and Lane et al. (1999), Ch. VIII.

liberalization, because it decreases domestic market competition, thereby leading to monopolistic behavior by the chaebols unless the latter face greater competitive pressure from abroad.

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The nature of political governance seems to have important effects on the effectiveness of financial and corporate governance. In good times, weaknesses in these areas are offset by high investment and growth rates; in times of crisis, the weaknesses become fatal. There seems to be little doubt that all three MSAs suffered serious weaknesses in these areas. An interesting question, which it is too early to answer, is whether meaningful strengthening of financial and corporate governance is more likely to be carried out in a relatively more democratic setting, and whether, when the starting point was a relatively more autocratic regime, like Indonesia's, the process of strengthening financial and corporate governance will be enhanced by simultaneous political reforms, or indeed even contribute to those reforms. In this connection, one may note that Korea, which has perhaps the most popularly accountable government among the MSAs, has also made the most rapid recovery since late 1997, although some of this may have been due to its initially more advanced economy and to such exogenous factors as the official pressure on foreign private creditors to roll over the debts of troubled Korean conflomerates.

## V. International Financial Arrangements and Domestic Governance[40]

We have discussed so far, in the context of the recent East Asian financial crisis, the political roots of the government's role in economic governance, and the interaction of that role with the forms of governance exercised within the financial and nonfinancial corporate sectors. The third and final dimension to our analysis of economic governance is international mechanisms of economic governance. In discussing this topic, we shall focus solely on international financial arrangements, which have been extensively debated since the onset of the East Asian crisis in July 1997.

There has been a tendency in this debate—though not by its most insightful participants[41]—to assume that international mechanisms of financial governance operate basically as intergovernmental arrangements. Since the signing of the Bretton Woods Agreement in 1944, the IMF has operated on a model in which each government—with variable skill and determination—pursues the encompassing interest of its polity, and that financial policies are in the hands of an

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[40] This section is based on a separate paper by Anthony Lanyi, presently being prepared, on "International Financial Architecture and Domestic Economic Governance."

[41] For example, there is certainly due regard taken of domestic governance in the excellent surveys by Goldstein (1998) and Eichengreen (1999), but these analyses stop short, for example, of looking at the interaction between different types of political regimes and forms of financial and corporate governance.

elite with strong international links, ensuring consistency of viewpoints and policies across countries. Even within the IMF, until the present day, this has been the explicit or implicit view of its staff, which deals largely with top central bank and ministry of finance officials who are largely technocrats, often with foreign education and international experience.

The reality, however, has proved much more complex. Over the years, policy makers have tended to be guided, in the first instance, not by international financial agreements, but rather by their ideologies, party or interest group agendas, political calculations (winning elections or support of key groups), or personal interests. Indeed, as Dahl has pointed out, there is an inherent tension between decisions stemming from international agreements and the processes of democratic government.[42] As a result of these political realities, many countries have tended to diverge from the international norm of prudent macroeconomic policies and gradual foreign trade and exchange liberalization.[43] However, since the early 1980s, most of these same countries, often under financial and political duress created by their external debt problems, have pursued policies in accord with the "Washington consensus:"[44] prudent fiscal and monetary policies, removal of government controls on both domestic and external markets, privatization of large parts of the state-owned enterprise sector, land reform and privatization of agricultural marketing, and greater openness to foreign direct investment.

But while policy makers began to conform more closely to the IMF ideal of a technocratic elite following similar policies throughout the world, the global financial market began to acquire a hitherto unimagined power to overturn even properly formulated economic policies of governments. For example, sudden, unexpected inflows of capital could put irresistible inflationary pressure on an economy where prudent fiscal and monetary policies were being pursued. East Asian countries in the early 1990s tried to solve the problem through a fixed exchange rate and rapid productivity growth. This allowed them to remain competitive in traded goods markets for awhile, but at the eventual price of inflation in the form of real estate and stock market bubbles, which in turn contributed to the financial market crisis in these countries.

It is therefore clear that more is now demanded of international financial arrangements than simply inducing governments to pursue the right policies and promoting multilateral commerce. The challenge now is to constrain the operation of increasingly powerful and liberalized markets, in order to avoid massive economic disruptions in emerging market economies, but to do so in ways that do not greatly impede foreign trade and investment. To put the problem in practical terms, how can market players participate in international financial cooperation? Alternatively, in

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[42] See Dahl (1998, 114-117).

[43] The reasons for the frequent failure of countries to comply with international commitments is discussed in World Bank (1997, 131-142).

[44] See Williamson (1993).

terms of the concepts employed in this paper, how can world international governance mechanisms interact both with the domestic political economy underlying the government's policies *and* the governance mechanisms operating within the domestic financial and non-financial business sectors? In this connection, one must note that governance mechanisms in *creditor* countries are also relevant here.

The beginning efforts to meet this problem date back to 1982. While big banks and big business have from time to time been mobilized to help deal with crises in individual countries, the first time this was done on a global scale was in reaction to the failure of Mexico to keep up with its external debt service payments, a failure which was made public in the summer of 1982. Late that year, Jacques de Larosiere, the Fund's Managing Director, realized that saving Mexico—and containing contagion to other countries—would require a joint effort by both official and private financial institutions, and so he informed representatives of the leading commercial banks that the IMF would refuse to undertake a program unless Mexico could demonstrate a feasible balance of payments outcome, which in turn would require roll-overs and rescheduling of the government's debt to foreign commercial banks. This approach, although involving painful stabilization programs and lengthy negotiations between the banks and a number of debtor countries, proved to be a successful first step in dealing with the debt crisis.[45]

Another eventual effect of the debt crisis was the intensification of efforts to establish international standards for banking and capital markets. Initial efforts among the Bank of International Settlements (BIS), starting with the establishment of the Basle Committee on Banking Supervision in 1975, whose members were the Group of Ten countries,[46] culminated with the establishment of international standards for capital adequacy in 1988. Ten years later, the standards have been extended to include all areas of banking supervision, summarized in the so-called "Core Principles for Effective Banking Supervision," which have been adopted not only by the "G-10" countries making up the Basle Committee but a large number of other countries that are members of 16 regional supervisor groups throughout the world.[47] A parallel development

[45] To put the 1980s debt crisis into present-day perspective, it should be noted that its impact will in all likelihood prove more widespread, deeper, and longer in duration, than the crisis beginning in 1997.

[46] Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States--actually 12 countries, not 10.

[47] The Core Principles are reproduced in Folkerts-Landau and Lindgren (1998). Some of the earlier history of the Basle Committee can be found in the IMF International Capital Markets reports of April 1989 and April 1990, The 16 regional supervisor groups are: Arab Committee on Banking Supervision, Caribbean Banking Supervisors Group, Association of Banking Supervisory Authorities of Latin America and the Caribbean, Eastern and Southern Africa banking supervisors Group, EMEAP Study group on Banking Supervision, Group of Banking Supervisors from Central and Eastern European countries, Gulf Cooperation Council Banking Supervisors' Committee, Offshore Group of Banking Supervisors, Regional Supervisory Group of Central Asia and Transcaucasia, SEANZA Forum of Banking Supervisors, Committee of Banking Supervisors in West and Central Africa.

concerns the regulation of securities market: here, too, initial efforts among the major industrial countries, through the International Organization of Securities Commissions (IOSCO), have been extended to other industrial and developing countries.

Against this background, then, the recent crisis has spawned new proposals for a revamped "international financial architecture." This fashionable jargon suggests through its semantics a lack of understanding of the underlying political and economic processes. As Stanley Fischer correctly noted at a recent seminar in Washington,[48] the older "international monetary system" seems a more realistic description, since it suggests a vast number of players operating in complex interaction with each other, while the architectural simile misleadingly suggests a simple, clear, mechanistic, fully controllable structure, which is hardly in line with the reality of 180-odd countries with a wide variety of political regimes, thousands of banks, and millions of firms and individuals involved in international trade and investment. In line with the architectural simile, proposals often seem to focus on *content*, some kinds of ideal mechanisms, while stopping short of analyzing the *process* by which they would actually be put into effect.

Let us then look briefly at the main proposals that have been made and assess them on the basis of the processes that would be necessary to make them meaningful. The proposals for international arrangements to prevent future financial crises fall into six categories:

1. Improving prudential and supervisory standards, for both lending and borrowing countries and institutions (this includes improved risk management in private global financial institutions).
2. Establishing an international lender of last resort.
3. Strengthening policy surveillance by international institutions.
4. Closely related to iii., a set of restrictions and taxes on certain types of capital movements.
5. Enforcing better transparency and disclosure in international financial markets.
6. Improving debt rescheduling procedures and reducing existing moral hazard in domestic and foreign borrowing operations.

Each of these recommendations embodies a number of propositions, and can be examined for their feasibility in view of the domestic political incentives and institutions in the affected countries. In short, what incentives do governments and private market participants have to comply with international rules and guidelines; and what institutions support compliance? How is international collective action fostered, and how is it limited by problems of domestic governance?[49]

*(1) Prudential and supervisory standards for financial markets*

[48] Stanley Fischer (1998b).

[49] On this general issue, see Sandler (1998).

It is well known that a properly functioning banking system—more generally, the financial system—requires a set of regulations that are properly enforced. Efforts to subject such regulations to international guidelines have been described earlier. From the standpoint of this study, the key questions of interest are whether an interventionist government is more or less likely to ensure compliance with international standards, and whether compliance is more or less likely under a democratic or autocratic regime. To date, countries with highly developed financial systems have tended to comply with standards promulgated by the Basle Committee and the IOCSO, mentioned above, because the principles of enforcing such standards have already been largely accepted in such countries.

The problem in debtor countries is for the technocratic elite (in the government and central bank) to persuade politicians and well-connected businessmen to accept more stringent standards for capitalization of banks and prudential supervision of financial institutions. Incentives for inducing "countries" to accept such standards have been discussed—e.g., IMF publication of the list of countries that have accepted such standards, or eligibility for certain kinds of Fund financial assistance. But such schemes may be viewed skeptically by countries that were previously able to attract foreign investment without these incentives being present, and there is the further obstacle that the leadership may not be able to persuade its political supporters and the private sector to cooperate. One must therefore conclude that countries tend to carry out reforms only in the midst of an economic crisis, with the strong push of Fund (or World Bank) conditionality; and this is unfortunate, because certain reforms, like financial sector restructuring, are much more costly when carried out during a crisis than during normal periods. Another important question, which bears further investigation, is whether a political system with democratic checks and balances provides, over the long term, a stronger base for adherence to international standards of financial sector and corporate governance, than does a relatively autocratic regime, with its penchant for nontransparent decision making and informal links between government and business.

*(2) Establishing an international lender of last resort.*

The drive for international standards in banking and securities markets suggests the analogy between national and international supervision. The Mexican crisis of 1994-95 and the Asian crises of 1997-1998 have raised another aspect of the analogy between domestic and international markets: namely, whether the well-known and established central bank function of "lender of last resort" (LOLR) can be translated into an international counterpart. The IMF appeared to assume a role of this sort in its management of the huge bailouts of Mexico in 1995, and of Indonesia and

Korea in 1997-8,[50] which were made up of both IMF resources and loans contributed bilaterally and by the World Bank. Yet even these financial packages were viable only if foreign creditors and wealthy residents also showed a willingness to roll over debts and keep their capital in the affected countries. However, the emergency nature of the bailouts made it difficult to organize the private creditors—who were more dispersed than in 1982--in a timely fashion;[51] and the behavior of residents depended in a sensitive and hard-to-control manner on the credibility of the government.

This experience has led a number of observers[52] to propose development of an international analogue to safeguards provided by a central monetary authority. In a mature, properly managed national financial system, banking collapse is avoided by a judicious combination of bank regulation and supervision on the one hand, and safeguards like deposit insurance and the willingness of the central bank to act as lender of last resort, on the other: the regulations and supervision mitigate the moral hazard created by the safeguards. In this way, even though individual financial institutions occasionally go bankrupt, overall confidence in the banking system is maintained and there is no systemic breakdown; while deposit insurance protects small and medium-size depositors. On an international plane, a LOLR would require a large fund available at short notice for rescue operations to countries facing sudden foreign exchange crises. Thus far, ad hoc rescue operations of the IMF, backed by loans from other IFIs and from some wealthy countries, have served this purpose, albeit imperfectly.

To analyze this analogy, let us first see what political economy considerations underlie arrangements for ensuring financial stability within a typical industrial country. The main task of the central bank and the bank regulatory authority, which are usually publicly appointed, is to support and maintain the stability and efficiency of the financial system.[53] If, instead, either of these authorities diverges from fulfillment of those objectives and seems to be motivated by the private interest of particular individuals or firms, they are subjected to attack by a free press and by democratically elected legislators, and face possible removal from their positions by the political authority.

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[50] The Mexican, Korean and Indonesian bailout packages were $48, $58, and $40 billion, respectively. The Thailand bailout was much smaller, $ 17 billion, although this was still large relative to the size of the Thai economy.

[51] See Goldstein (1998), 37-44, 50-53.

[52] See, for instance, President Clinton's address to the Annual Meetings of the World Bank and International Monetary Fund, October 6, 1998. Recently, Fischer has provided a thorough analysis of this analogy (Fischer, 1999).

[53] The chains of command and responsibility are especially complex in the United States, with several supervisory authorities and an independent central bank with quasi-independent regional Federal Reserve Banks that appoint their own boards. But the bottom line is that the Federal Reserve system derives its authority from Congress, and is institutionally obligated to work in close coordination with the President and the Secretary of the Treasury.

In contrast to this arrangement, the incentives and penalties in an international version of this structure are quite different from this. There are, of course, incentives for a national government to comply with international agreements, as well as disincentives for not complying—and proposals for an international LOLR focus on setting up such incentives and disincentives. But these incentives and disincentives are limited compared to those on the national level. For one thing, since international rescue operations are motivated by avoidance of "contagion effects" and thereby an international financial crisis, it is unlikely the IMF and G-10 could refrain from assisting a country, even if the latter has not met the required standards for macroeconomic policies and supervision of financial institutions. For another, national governments face not only international incentives but also their own domestic priorities, the interests of their supporters, the sentiments of their electorates (including specific interest groups), and media opinion. A national government therefore has much less incentive to follow international rules than does a domestic commercial bank. Furthermore, its ability to misinform an international agency is greater than its ability to misinform its own domestic constituencies, and also greater than the scope for a domestic bank to hide information from a national banking authority. An international lender of last resort therefore faces much greater problems of asymmetric information than does a domestic central bank.

It is debatable whether an international LOLR would be better off dealing with national governments that are democratically based or with those that are autocratic. On the one hand, an autocratic government, convinced of the advantages of adhering to an international code of good behavior linked to the possible benefits of an international LOLR regime, might find it easier than a democratic government to overcome domestic opposition. On the other hand, a democratic government is likely to promote greater transparency of banking information, because this is insisted upon by national legislators, and is therefore less likely than an autocratic government to be able to hide relevant information from an international authority.

*(3) Strengthening policy surveillance by international institutions*

Surveillance by the IMF consists of a process of consultation with all member countries, involving data collection and discussions with member country authorities carried out by the Fund staff, and discussion of reports by the IMF Executive Board. The impact of such consultations, however, are generally thought to be minimal, except in those cases where the country either has a program with the Fund, is in the process of negotiating a program, or is likely to enter a negotiation. Restricting the discussion to those cases where Fund policy advice has some impact, the question arises as to the political process by which this advice is translated into practice. The ideal scenario goes something like this: the Fund staff, backed by the management of the relevant area department, as well as by the Managing Director, interact with country officials, to produce a consensus solution, which is then explained to and accepted by the political authorities, who in a democratic system, explain it to and receive at least majority political support from the public. Finally, civil servants translate the agreed policy measures into effective practice.

The possible shortfalls from this ideal scenario are numerous and fairly obvious. In practice, quite apart from problems of competence and available information at the levels of both the Fund staff and the member-country government, there is a whole string of principal-agent relationships. A major relationship of this sort is that between the Fund's shareholders—of which the G-10 countries have 50% of the votes at the Executive Board—and the Fund management, which must carefully take into account the views of the major countries.[54] Without discussing principal-agent problems within the Fund—although these can be non-trivial—the relationship between the member country government and the Fund staff is itself complex and fraught with lack of transparency on both sides. Such non-transparency can reach the point where—as in Russia, Korea and Thailand recently, and in Hungary, Mexico and the Philippines in well-known episodes of earlier years—the member-country central bank hides crucial information from the Fund staff. Serious problems of transparency and communication can also arise between the country's own technicians and its political leadership—sometimes simply through the difficulty of explaining technicalities to economically unsophisticated leaders—and between the political authorities and the electorate (assuming some degree of democracy), where the leaders tend to accentuate the positive, and downplay the painful aspects of an economic program. Further problems relate to the relationship between the government and the private sector, where the government is often unwittingly guilty of poor communication with regard to the regulations and taxes it imposes on the private sector, while the latter, often quite wittingly, is nontransparent about the information yielded to the authorities regarding company accounts and operations.

The consequence of this chain of asymmetric information and different principal-agent relationships is that policies "agreed" by the Fund staff and the country authorities may sometimes be only partially carried out by the latter, sometimes with the tacit compliance of the Fund, which seeks to avoid upsetting a delicate domestic political balance, or disturbing financial markets, or damaging the relationship between the Fund staff and the national government. Even when a government is honestly trying to carry out an agreed-upon program, its relationship with its electorate and with the private sector may constrain its ability to accomplish what it intends. It should nevertheless be noted that despite these difficulties, genuine agreement on Fund-supported

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[54] Discussion of the IMF as if it were an autonomous agent--saying "the IMF decided this" or "the IMF imposed that"--is unrealistic to the point of absurdity. Nevertheless, this is the standard format of the criticism of IMF policies. It would be much more interesting to examine, say, the roots of American (or European or Japanese) views vis-à-vis Fund-supported programs.

adjustment programs is often achieved, and such programs are often, at least in good part, actually carried out. Such outcomes are testimony to the professionalism and diplomatic skills of both IMF staff and their member-country counterparts—as well, perhaps, to the decades-long experience with international monetary cooperation, buttressed by impressive amounts of technical assistance and training provided by the IMF, World Bank, and other donors, not to speak of successful efforts by the emerging market country governments themselves.

*(4) Restrictions and taxes on capital movements*

A prominent international economist recently cited as the main argument against restrictions on international capital movements that he himself would not want to live in a country that had such restrictions.[55] This shrewd observation underlies the point that policies with regard to capital account liberalization are in practice based not on standard macroeconomic reasoning but on two other main considerations: first, the path-dependent status quo ante; and second, the interests of the business community and the relevant players in the government. The reason the first is important is because changing an existing system always involves difficulties and risks. The second reason is related to the first but requires more detailed analysis.

Who are the winners and losers from a system of capital controls? With regard to controls over *capital inflows*, the winners are clearly those domestic financial institutions or investors who are protected—in the same sense as import tariff protection—from market entry from foreign financial institutions or investors. Other winners include those market players who, in a system where certain types of capital inflows are allowed, gain rents from being permitted to borrow or receive investments from abroad. The losers are those who are excluded from the domestic credit market but who might be able to obtain credit if foreign funds were allowed to flow in—mainly because this is likely to raise the overall availability of credit. The losers might also include the government, because if it must borrow to finance fiscal deficits, the cost of such borrowing is likely to be larger if banks' borrowing abroad is prohibited or restricted.

With regard to *capital outflows*, those who lose from restrictions are clearly those who have capital to invest abroad: i.e., enterprises and wealthy individuals. The government may gain from the greater policy freedom provided by capital controls, and from the possibly lower interest rates resulting from the greater availability of local capital, but most economists would argue that the long-run costs of such restrictions are greater: i.e., less investment from abroad (because of possible difficulties in repatriating funds) and consequently less economic growth.[56]

[55] Cooper (1998).

[56] See Tamirisa (1999).

Like Keynes, some economists now believe that it might be possible to discourage "bad" capital movements—short-term speculative purchases of equities by nonresidents and short-term foreign borrowing by domestic banks—while continuing to encourage "good" capital flows, such as foreign direct investment. This is a technical issue beyond the scope of this paper. The question relevant here is whether the "good" and "bad" capital flows are seen as such by the policymakers and their private-(or SOE-)sector constituents: recent evidence is mixed. As long as this remains a politically ambivalent issue, collective action to impose a "rational" international regime in this area is exceedingly unlikely.[57]

*(5) Better transparency and disclosure of financial information*

There has been widespread agreement that lack of transparency with regard to the financial position of the government and the central bank, and with regard to commercial banks and non-bank corporations as well, have contributed negatively to the financial difficulties, not just in the MSA countries but also in Japan and Malaysia. While this general perception may be supportable by analysis, however, it needs to be dissected into its several parts, as each information asymmetry involves different incentives and consequences. The chief asymmetries involved are between: the international official community (represented by the IMF) and the national government, the private sector and the national government, and individual private sector entities and "the market" as a whole.

As suggested earlier, the withholding of key information by national authorities has been a perennial problem faced by international organizations. Incentives for better reporting by Fund member countries—for instance, making timely and complete information a condition for emergency financial assistance—are both weak and non-credible: weak, because a determined government with an apparently successful economy knows that market participants will overlook pedantic details like statistical reporting, and non-credible, because emergency assistance may be given even to an undeserving member country if the alternative is global financial contagion. While international financial institutions should not be discouraged from announcing and attempting to impose statistical standards, and privately remonstrating with central banks and other responsible agencies, the best guarantee of statistical transparency is domestic political transparency. Since the latter can hardly be imposed in any direct way from abroad, the international community needs to continue to preach the benefits of democratic institutions through any media and political channels possible, at the same time not expecting overnight changes in previously authoritarian polities and societies.

[57] Of course, these chances are not improved by the fact that economists themselves disagree sharply about what constitutes a rational regime!

A national government's ability to comply with international data disclosure requirements of information depends crucially on the disclosure of information by the private sector to the national government. It is our view that such disclosure is more likely to be comprehensive and accurate in democratic than in authoritarian regimes, and, among the latter, in those regimes (usually with democratic or oligarchic elements) that are committed to market-augmenting government. This is because the greater commitment of democratic regimes to the rule of law will tend to build stronger moral authority for national governments to demand correct information from firms. The greater likelihood of direct links between government officials and financial or corporate entities under an authoritarian regime also implies greater discretionary exemption and shielding of such entities from data reporting requirements; and an authoritarian government implies more restricted scope for independent monitoring, by civil society and the media, of data reporting by enterprises. A political commitment to market-augmenting government tends to lead to greater availability of enterprise data to the market as a whole, and therefore also to the government.

Finally, the accuracy and completeness of reporting earnings, profit, and other financial data by private sector entities *to the market* is a function of the extent of market development and, both directly and indirectly, market-augmenting government.[58] The latter, for instance, determines the extent of shareholders' rights, disclosure requirements in stock and bond markets, collateral registries, and other public sources of data on individual firms. It also helps determine the overall development and sophistication of markets, one aspect of which is the existence of specialized firms dedicated to collecting and providing (for a price) data on particular markets and individual firms. Since market-augmenting government is more likely to be fostered in democracies—although there are exceptions—one may hypothesize a tendency for the prevalence and strength of democratic institutions in a country to be correlated with private sector reporting. Future research should seek to test this proposition.

*(6) Improved rescheduling procedures and reduced moral hazard in domestic and foreign borrowing operations*

There is both an international and a related domestic aspect to this question—actually, two domestic aspects, one relating to the creditor country and one to the debtor.

1. There is the question of how to compel creditors, in the wake of a crisis, to take active part in rescheduling operations, so as to reduce the impact of the crisis on both the

[58] When such data is reported, it is more firm-specific than data that governments make public, which tend to be aggregated so as not to reveal data on individual firms or persons. For instance, tax statistics from the Internal Revenue Service, or bank statistics published by the Federal Reserve Board, are structured carefully so as to make it impossible to discover data for very large entities that are well-known in the market.

financial sector and real activity. Being able to do so would reduce the moral hazard of lending abroad from the standpoint of the creditor country.

2. Closely related to this question is how creditor countries, through the instrumentality of normal prudential supervision and regulation of financial institutions, can induce or compel such institutions to exercise restraint in their build-up of short-term asset positions in emerging market countries.
3. Finally, there is the question of how to reduce moral hazard with regard to foreign borrowing by financial institutions and nonfinancial corporations in the debtor countries. One of the most harmful features of the financial systems in the MSA countries of Asia was the explicit or implicit guarantee to bail out banks that could not meet their debt-servicing obligations: not only did this imply the normal lender-of-last-resort function by the central bank, but was complicated by the foreign-currency denomination of the debt, implying that such debt was backed not only by the central bank's power to create domestic money but also by its international reserves.[59]

The Basle Committee is already working on the second of these problems, and it is surely within the Committee's scope, and that of domestic financial regulatory authorities in creditor countries, to work on the first. The greater difficulty, from a political economic standpoint, is with the third aspect. Here, the ability of debtor countries to reduce moral hazard within their systems depends to some degree on issues already discussed: for example, the transparency of financial data vis-a-vis both central bank and the market, and the arm's-length relationship between the government and individual financial institutions or nonfinancial corporations. Without reliable data, the government is unable to monitor the overall situation and may suddenly find itself in the midst of a crisis that it has no choice but to battle as best it can, including bailouts of banks and other entities. Cronyism between government and the private sector reduces the credibility of any policy that denies even implicit guarantees to banks or corporations in trouble. Here too, then, the effectiveness of any schemes that posits possible future international assistance on maintaining a preferred financial regime in a debtor country depends crucially on the governance characteristics of the existing regime in that country.

## VI. Summary and Conclusions

[59] See Goldstein (1998), 46-53.

At the outset, we warned the reader that this paper would raise questions rather than answer them, and in conclusion, we would like to summarize some of the questions we believe need further investigation.

On the **political basis of economic governance,** we have only suggested a few hypotheses regarding the kind of political regimes likely to produce an effective, growth-enhancing, market-augmenting government. One is that the type of political regime that is especially effective in the early stages of economic development may be less suited to fostering the creation of a full-fledged, sophisticated market economy at a later stage. There certainly seems to be some indication of this in the Asian experience, where authoritarian, paternalistic regimes fostered rapid growth when these economies were at relatively low income levels, but seem to be evolving toward more democratic models to deal with demands for greater market autonomy. But even if a case can be made for the desirability of democratization as a market economy becomes more sophisticated, the varied historical examples suggest the need to find out more about the conditions under which either an autocratic or a democratic government can be market-augmenting, or not. It would also be useful to find historical examples of, and develop plausible scenarios for, the transition from discretionary to arm's-length approaches to state economic governance, and to define the most effective ways in which the international community might assist with this transition.

Empirical work on **macroeconomic governance** would need to tap into the huge literature on macroeconomic policies and their effect, and link existing work with variables that reveal the quality of governance. Unfortunately, such variables are hard to quantify; but perhaps a taxonomy of regimes (see above), together with a taxonomy of the way macroeconomic policy is organized, as discussed in Section III, could yield ways of exploring the relationships between the political and administrative variables, on the one hand, and the more familiar economic ones on the other.

In Section IV of our paper, preliminary attempts are made to trace the relationship between empirical indicators of **financial and corporate governance** with some governance variables that have been developed by others. But these attempts are hardly the last word on the subject; one needs to look more carefully, perhaps through case studies, at the realities of financial and corporate governance in particular cases. And again, what is lacking is a linkage between indicators of these types of governance with the more carefully articulated taxonomy of political regimes alluded to above. Specifically with regard to the adjustment of MSA countries to the East Asian crisis, it would be interesting to examine the reasons why recovery in Korea has been more rapid than in the Indonesia and Thailand.

Finally, one of the authors is at work on a more detailed examination of proposals for improving the **governance of the international monetary system**, from the standpoint of how realistically these proposals are related to the actualities of domestic economic governance, especially in emerging market countries. This topic is terra incognita, as it has for generations been debated and practised by a small elite that tends to perceive the bothersome realities of domestic politics as a case-by-case problem, rather than part of the "system" itself. The growing power of global financial markets, and their linkages to effective domestic financial governance in both the major industrial countries and the emerging market economies, has rendered such a stance increasingly untenable.

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## Appendix 1. Reform Measures Taken since the Crisis

| Structural Reform Measures | Governance Mechanisms | Governance-Enhancing Measures | Indonesia | Korea | Thailand |
|---|---|---|---|---|---|
| Governance from creditors | Bankruptcy law | Overhaul of bankruptcy law | Strengthening of the laws in April 1998; transparent court fee system, appointment of ad hoc judges, effective enforcement, training of judges | Strengthening of the laws in Feb 1998; creation of bankruptcy commission, study to examine set-up of additional bankruptcy courts; creation of bankruptcy commission to assist Seoul District Court in insolvency litigation | Overhauling of bankruptcy law in Oct. 1998: allowing unsecured creditors to file their claims; provision of voting on a reorganization proceeding; specific rules on rejection of outstanding contracts |
| | Enhancing accounting standards and requiring Information disclosure[60] | International accounting standards | Accounting standards consistent with international standards by Dec. 1998 | Accounting standard complying with IAS 30 | In process based on the new law |

[60] This is related also to governance from other channels, especially governance from shareholders.

| | |
|---|---|
| Information disclosure | Chaebols required to disclosure all liabilities to their major creditor banks; biannual audited financial statements by 8/31/98 and quarterly unaudited financial statements by 1/1/00; consolidated statements; disclosure of transactions by large shareholders |

## Appendix 1. Reform Measures Taken since the Crisis - continued

| Structural Reform Measures | Governance Mechanisms | Governance-Enhancing Measures | Indonesia | Korea | Thailand |
|---|---|---|---|---|---|
| Governance from creditors – continued | Enhancing accounting standards – continued | Strengthening non-governmental self regulatory institutions | | Strengthening of KICPA, non-governmental regulatory body | |
| | Secured lending | | | | Increase and improve collaterable assets, strengthening of security rights |
| | Arbitration law | | A new arbitration law consistent with international standard by Dec. 1998 | | |
| Governance from shareholders | Enhancing minority shareholder right | One share one vote | No | Yes | No |
| | | Cumulative voting/proportional | No | No, to introduce 2nd half of 1999 | Yes |
| | | Penalties for insider trading | Yes | Yes | Yes |
| | | Class action suits | | Class action suits against executive and auditors | |
| | Enhancing accountability of corporate boards | Outsider on board or audit committee | | Listed companies required a min of 25% outsider on board | Set up of an audit committee for each listed company by end 1999 |

## Appendix 1. Reform Measures Taken since the Crisis - continued

| Structural Reform Measures | Governance Mechanisms | Governance-Enhancing Measures | Indonesia | Korea | Thailand |
|---|---|---|---|---|---|
| Governance from shareholders - continued | Capital market development | | | Creation of mutual funds; expansion of sovereign debt; Issue and implement comprehensive M&A guidelines | |
| | Privatization | | Divestiture of 12 SOEs by 3/99 | Privatization of 5 SOEs, additional 6 by 2002 | Strong emphasis given to privatization; privatization of infrastructure firms |
| Prudential regulations | Consolidation of financial institutions | Initial number of financial institutions | 222 | 169 | 142 |
| | | Closure | 59(26.6%) | 10(5.9%) | 56 (39.4%) |
| | | Nationalization or under supervision | 43(19.4%) | 2 (1.2%) | 18 (12.7%) |
| | | To be merged | 4 (1.9%) | 5 (3.0%) | 0 |
| | | Bought by foreigners, joint venture | 0 | 2 (1.2%) in process | 4 (2.8%) |
| | Mechanisms dealing with non-performing loans | Definition of NPL | 3 mos. Overdue by 2001 | 6 mos. Overdue, moved to 3 mos | 3 mos. Overdue by 2000 |

| | | | | | |
|---|---|---|---|---|---|
| | | General provision (% of loans) | 1% | 0.5% | 1% |

## Appendix 1. Reform Measures Taken since the Crisis - continued

| Structural Reform Measures | Governance Mechanisms | Governance-Enhancing Measures | Indonesia | Korea | Thailand |
|---|---|---|---|---|---|
| Prudential regulation – continued | Capital adequacy and loan classification | Capital adequacy requirements | 9%, 12% by 2001 | 8% | 8.5% |
| | | Tightening of loan classification standards | Lagged behind relative to capital adequacy | Lagged behind relative to capital adequacy | Lagged behind relative to capital adequacy |
| | Strengthening supervisory authority | Independence | Draft law to institutionalize Bank Indonesia's autonomy | Unification of supervisory organization by 1/1/99 | |
| | | Upgrading supervisory skills | In process | In process | In process with help from the World Bank |
| | Risk management | Risks associated with short-term foreign borrowing | Set-up of foreign exchange monitoring system | 70% of ST loan matched by ST asset | New Financial Institutions Law enact by mid 1999 |
| | | Risks associated with a single borrow | | From 45% to 25% in July 2000 | In process; the new law |

| | | | |
|---|---|---|---|
| Deposit insurance scheme | Not exist before the crisis; covering all bank depositors for a period of two years was introduced in Jan 1998 | Existed before the crisis; broad-based guarantees to calm depositors; will be replaced by a funded and more limited deposit insurance system | Not exist before the crisis; broad-based guarantees to calm depositors; will be replaced by a funded and more limited deposit insurance system |

## Appendix 1. Reform Measures Taken since the Crisis - continued

| Structural Reform Measures | Governance Mechanisms | Governance-Enhancing Measures | Indonesia | Korea | Thailand |
|---|---|---|---|---|---|
| Promoting market competition | Trade liberalization | Reduction of trade barriers | Reduction of tariff to a max of 10% for nonfood agri products by 2003; Reduction of tariffs on chemical, steel to 5-10% by 2003; Phase out quota and non-tariff barriers | Phase out Import Diversification Program | In process |
| | | Elimination of restriction on foreign investment | Elimination of restriction in retail and wholesale trade | Enact the Foreign Investment Promotion Act; open markets for security dealings, insurance, & leasing | Conversion of the Alien Business Law into a new and more liberal Foreign Investment Law; Amendment of the Land code to allow to own residential land |
| | Competition law | | In process | | |
| | Promotion of domestic competition | Elimination of monopoly | Abolition of the monopoly of the state trading agency (BULOG) over the importation and distribution of essential food items. | | |
| | | Promoting of mobility of commodity within the country | Elimination of provincial and local export taxes | | |

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